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Quarterly Commentary

4th Quarter 2016

Teamwork

We always try to count our blessings around here, but it seems that year-end is always a special time for reflection and appreciation for those whom are important in our lives. For us, that starts with family and our clients (and if you happen to be both, we are doubly appreciative!).

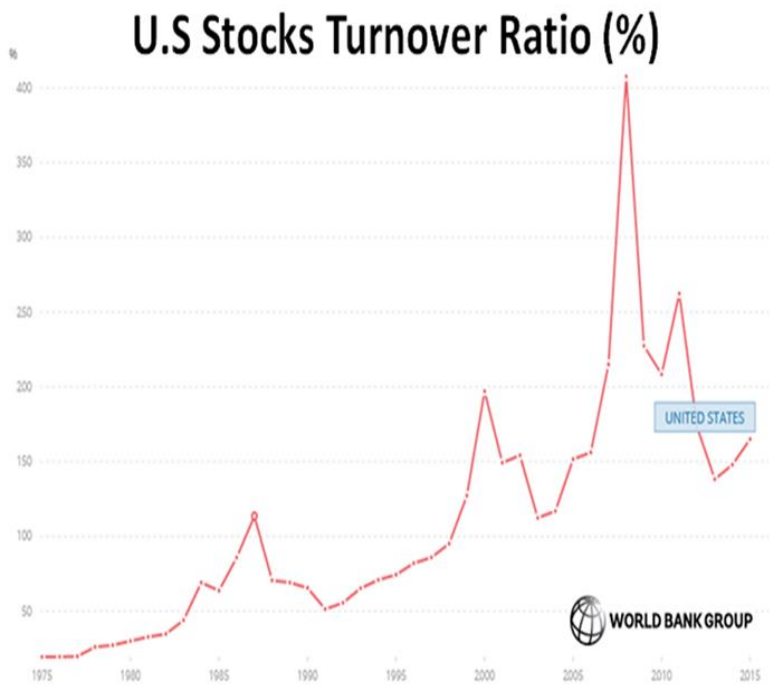
The longer we are in this business, the more we realize that any success in achieving the investment objectives our clients have laid out for us is the result of teamwork. The success we have achieved for our clients over the long-term is a product of hard work and discipline on our part. We devoted much of last quarter's commentary explaining how our research process works. **Equally important ingredients in the recipe for success are patience, involvement, communication and trust on the part of our clients.** We know this for a fact, because we have experienced it. We know that our clients must provide these ingredients for the team to achieve its goals.

It is not easy being a value investor, nor is it easy being a client of a value investor. We understand this fully and believe that if it were easy, everyone would be doing it. Most are not for that very reason...it's not easy! In fact it is probably best that a value investor be a little bit masochistic, because it is guaranteed that you will undergo some short-term pain in exchange for the hope of long-term gain.

As we stated above, we have been very blessed with patient clients throughout our careers.

Patience in investing, however, and dare we say society in general, is a more rare trait than ever before. In equity investing, this is borne out by the fact that the average holding period for a New York Stock Exchange traded stock has diminished drastically in the last 75 years, really picking up pace in the last 25 years. According to Reuters, the average holding period in the late 1930's was 10 years. Today the figure stands at somewhere around 6 months. The chart on the following page from the World Bank shows the turnover rate for U.S. stocks. Think of the turnover rate as the number of times a portfolio "turns over" in a year. Thus, a 200% turnover rate would mean that the average stock in a portfolio turned over twice a year, or stated another way, the average holding period for a stock would be 6 months. You can see from the chart that the long-term

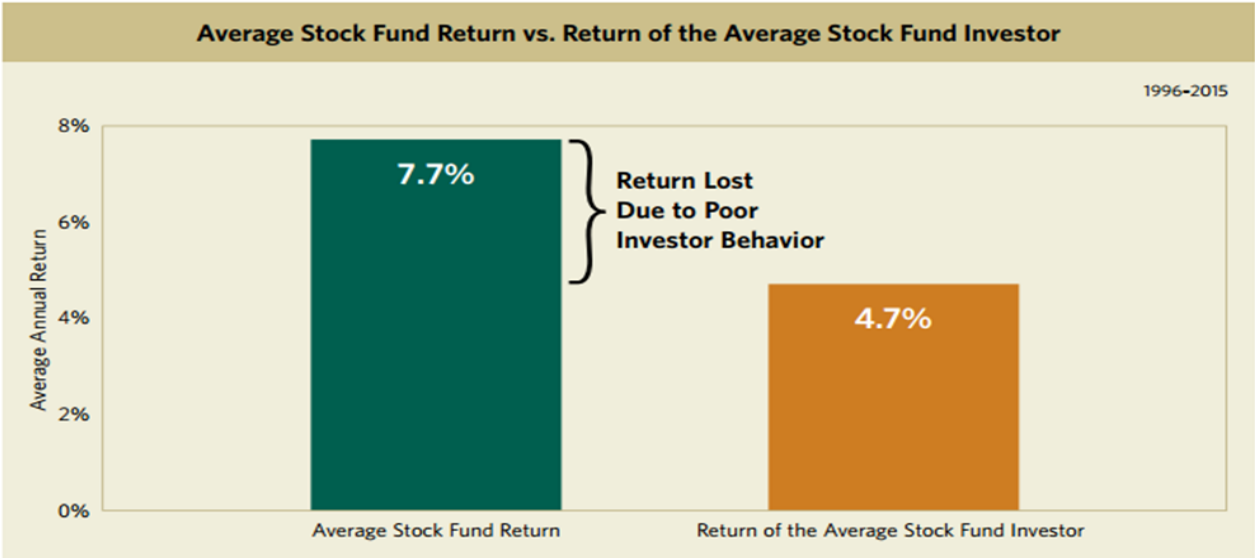
turnover trend is increasing, despite the fact that turnover has calmed down since the financial crisis.



Contrast this trend with FRM’s long-term turnover ratio, which is a fraction of the trend illustrated above (a rough number for our long-term turnover would probably be somewhere between 15%-20%).

Perhaps an even more illustrative example, from the clients’ point of view, of how a lack of patience can impact investors negatively is from a study of average long-term stock mutual fund returns when compared to the average return for actual stock fund investors. The illustration below from Dalbar, Inc. shows that since 1995, the average total return for U.S. equity mutual funds of 7.7%

greatly exceeded the actual experience of mutual fund holders during that time, only 4.7%. As we cited in our first quarter commentary of 2016, other studies show even larger differences in average long-term results of mutual funds when compared to returns of investors in the fund.



Source: Davis Funds, Quantitative Analysis of Investor Behavior by Dalbar, Inc (March 2016) and Lipper. Dalbar computed the “Return of the Average Stock Fund Investor” by using industry cash flow reports from the Investment Company Institute. The “Average Stock Fund Return” figures represent the average return for all funds listed in Lipper’s U.S. Diversified Equity fund classification model. Returns assume reinvestments of dividends and capital gain distributions.

The average investor's underperformance was a direct result of losing patience and pulling money out of the funds at exactly the wrong times.

The trend toward increasing impatience among investors should lead to more frequent disparities between price and value. We believe that if we continue to be blessed with clients whose patience exceeds most investors, this long-term trend should work to our mutual benefit as value investors.

Client involvement is another important contribution to the recipe for investment team success. We encourage our clients to be involved to the extent that they are informed and knowledgeable about our approach and the reasons actions are being taken. To this end, we encourage our clients to read this commentary every quarter and to meet with us annually to gain a better appreciation for the work performed, which underlies the moves being made. Without this understanding, it is human nature for the client to over-emphasize short-term performance, which is never a good idea. It is easy for an uninvolved client to cut and run when short-term performance has not been good, or to get overly enthused when short-term performance has been good. To repeat, overreaction to short-term performance often results in the client making the wrong move at the wrong time, exactly the finding of the aforementioned Dalbar study.

Communication, while similar to client involvement, is different in that it involves sufficiently keeping us informed about changes or events that might impact investment objectives or investment actions. A good example might be a change in a client's liquidity needs or tax status. Additionally, we encourage our clients to ask questions if an action taken in the portfolio or some other aspect of the relationship seems to run counter to what was expected. We believe those types of questions are best addressed as soon as possible, and we ask our clients not to delay in addressing them with us. We strive to excel in our communication with our clients, as this is one aspect of our work that we can control. However, we need updates, feedback and questions from our clients so that a two-way communication process will lead to a successful long-term relationship.

To a certain degree, the **trust** our clients place in us and our work is earned over time. However, we recognize that hiring a portfolio manager takes a certain leap of faith on the front-end. That leap of faith is usually based on our reputation, our historical results and through face to face interviews. We recognize that this leap of faith is no small thing, because we ask every client to give us a handshake agreement (not a legal agreement) that they will give us a minimum of five years before making a judgment about our work. We believe this is the bare minimum amount of time for making such a decision and the first data point at which performance information becomes meaningful. We do this to give our clients (and us) the highest probability for success. Also on the front end, our business model assures that the client's assets can only be controlled by the client through their third party custodian. Our limited power of attorney extends only to making securities transactions within the account. We cannot move our clients' assets. Additionally, we make every effort to make sure that our clients understand our advisory fee and billing structure and how fees are calculated. The financial industry is mostly one that goes to great lengths to

obfuscate fees, and in so doing has generated a great amount of distrust. We want our clients to have a clear understanding of the fees they are paying, right down to the penny.

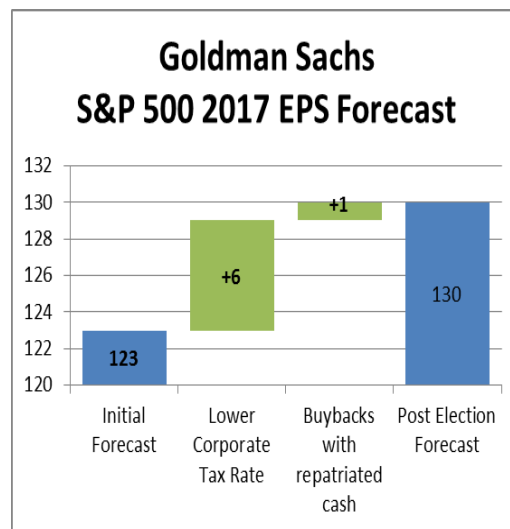
As our relationships with our clients mature, hopefully they begin to understand and appreciate the work that is going into the management of their assets. We strive to improve every day, and hopefully over time, our clients notice our efforts. An important part of this striving for continuous improvement is laying the groundwork for taking our investment discipline into its third generation. We believe we have assembled a very strong team of value investors that will benefit our clients for several decades to come.

Without the key ingredients of patience, involvement, communication and trust from our clients, we and our clients would not have enjoyed the long-term success we have been so fortunate to realize. Success in achieving investment objectives requires teamwork. There is no “I” in team!

The Trump Rally

There has been lots of ballyhoo around the Trump rally that actually began the Monday before Election Day. Much of the rally offset nine straight days of decline prior to the beginning of the upswing. Year-to-date total return had shrunk to about +3% for the S&P 500 prior to the rally, but ended the year at +11.96%.

As usual, we don’t have a lot to say nor do we spend a lot of time trying to analyze market action, but we did try to put some thoughts around what Trump’s corporate tax cut plans might mean from a broad market earnings perspective. As you can see from the nearby chart, Goldman Sachs estimates that earnings for the S&P 500 will rise roughly 5.7% due to tax rate cuts and the easing of taxation on the repatriation of corporate cash. So given that the broad market rose almost 9% in the Trump rally through the end of the year, it seems to us that the good news is more than reflected in stock prices in general.



Since about mid-2013, we have appraised stock prices as generally high to very high. While we are encouraged by the discussion of corporate and individual tax rate cuts, the overall market has expanded valuation for several years. While we never know the direction of future markets, it has been our experience that highly valued markets tend to eventually come down to the fundamentals as opposed to fundamentals growing into high valuations.

Year-End Review

2016 was a bounce-back year for our equity performance. It was the first calendar year since 2006 that value stocks out-performed growth, although our under-performance cycle did not begin until

2011. Our composite performance out-performed both value and growth benchmarks letting us breathe a big sigh of relief for the time being. While hopeful that a good performance cycle has begun, we recognize that one year does not make a trend.

Our best performers were in the mining and energy industries. Mining was highlighted by a big rebound in operating performance and stock price in **Teck Resources**, by far our best performer of the year. Energy was a mixed bag, however, as exploration and production of oil and gas came back on higher prices, but refining was only slightly additive and drilling continued to be a drag.

Another area of good performance in our portfolios were the companies where we consider the CEO to be a portfolio manager of businesses. We have several of these, including **Fairfax Financial, Berkshire Hathaway, Leucadia, Loews and Seacor**.

Our investments in “old technology” companies continued to be very good performers in 2016. **Corning, Cisco, Intel and HP, Inc.** did very well. Ditto for **HP Enterprises** and **Lexmark**, which were sold at substantial profits during the year.

Our large positions in **Merck, Sanofi and Pfizer** were only slightly positive as a group.

In Closing

While there is nothing new to report in the grandbaby competition, check this space next year because there is breaking news from the Millsap/Ivory camp. Additionally, Gray Millsap, who is in his final residency year in emergency medicine, became engaged. He and Maggie, who will wed this September, have only dated for about eight years, so Mark and Mary are worried that Gray may be rushing things a little.

Even though there were no new grandbabies to announce, there was a new addition to the FRM family. James William Sanders was born to Lauren and Will Sanders on October 19, 2016. James weighed 7 pounds and 2 ounces and measured 20 inches long. He is a very handsome lad that reportedly likes to entertain during the middle of the night. Lauren just returned to work right after Christmas, but ever the peppy one, you would never know she has missed any sleep.

The Hill gang marked a new milestone when their oldest daughter, Sarah, married Kyle Bruner of Stephenville, TX. They are starting out in a little village called Dallas, where Kyle is a CPA and Sarah continues her career with Essilor. Tom is still coping with the new sleeping arrangement when the newlyweds visit Little Rock.

As we look to the promise of a new year, we wish for you and your families good health, happiness and success throughout 2017. We sincerely appreciate the relationship we have with you and are thankful for your patience and the trust and confidence you have placed in us. If there is a way that we may serve you better, please do not hesitate to let us know.